CONTRACT INCENTIVES

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Overview

- **Incentives Overview**
- **Contractor's Perspective**
- **Current Incentives**
- **Future of Incentives**

INCENTIVES OVERVIEW

Incentives

- Goal is to encourage and motivate optimal contractor performance in areas deemed critical to an acquisition program's success in the following areas:
  - Performance
    - Focus on outcomes, not processes
    - Usually objective criteria
  - Cost
    - All incentive contracts must include an incentive to control costs
  - Schedule
    - Target a commitment from the contractor to deliver a system or objective at a time desired by the customer

- Tools
  - Contract Type
  - Award Fee
  - Profit Policy
  - Performance Based Contracts
  - Payment Provisions

Contractor Performance and Risk

- Incentive-fee contracts are generally considered objective
  - The contractor's performance is evaluated to determine fee amount
- Government has flexibility to mix and match characteristics from different contract types
- Risks to both the Government and contractor should reflect the uncertainties involved in contract performance and the environment
  - Competitive environment
    - Amount earned depends on seller's ability to control costs
  - Non-competitive environment – utilize Weighted Guidelines to assess
    - Skill mix/resources required to perform the job
    - Amount of cost risk assumed by the contractor
    - Amount of capital investment employed
  - Other factors

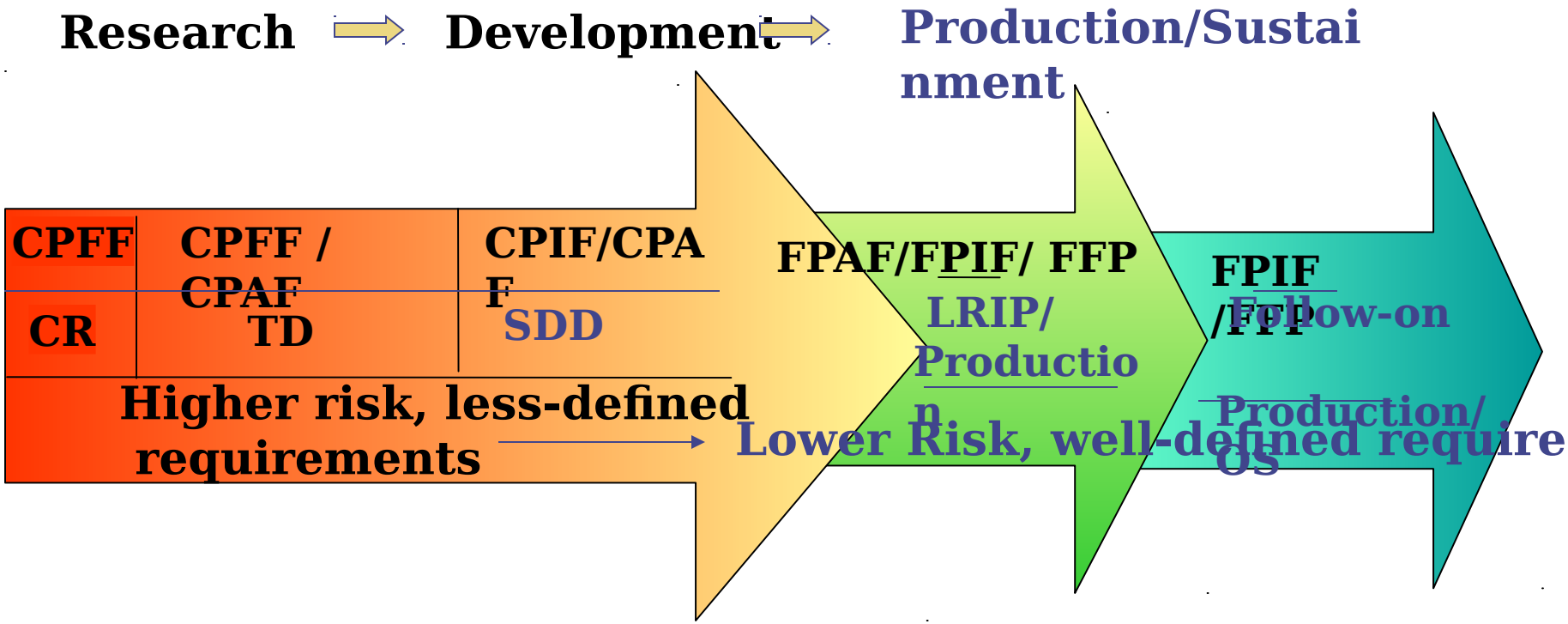
Types of Contracts

- Fixed Price Contract (FP)
  - Contractor has responsibility for performance cost and profit
- Fixed Price Incentive
  - Firm Price Incentive Firm
  - Fixed Price Successive Targets
  - Fixed Price Award Fee
- Cost Reimbursement (CR)
  - Government assumes responsibility for costs and pays a predetermined fee
- Cost Plus Incentive
  - Cost Plus Incentive Fee
  - Cost Plus Award Fee

Comparison

- Fixed Price
  - Guaranteed performance
  - Paid upon delivery or contract financing
  - Profit related to performance
  - Technical maturity
- Cost
  - “Best effort”
  - Costs paid as incurred
  - Fee agreed up front
  - Scope not well defined

CR FP continuum

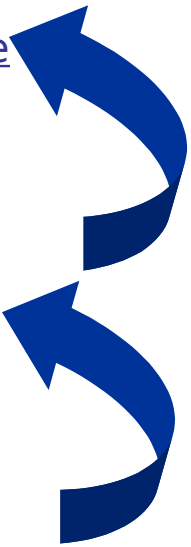


Greater Performance Risk = Government Assumes More Cost Risk

CONTRACTOR PERSPECTIVE

Contractor Financial Performance Drivers

- As publicly traded corporations, contractors must answer to shareholders / investors
  - Shareholders demand adequate return on their investment (stock price appreciation & dividends)
  - Stock price reflects the market's assessment of the company's future cash flows
- Future cash flows are determined by:
  - Profitability (profit growth and profit margins)
  - Asset Efficiency (e.g., receivables, capital investment)
  - Investment decisions (e.g., equipment / facilities, R&D, people)
- Contract structure and performance drive cash flows
  - Contract Structure: Margin/ROC %, Billing Terms, Other Ts&Cs, required level of investment
  - Performance: program execution, customer satisfaction



Investment decision and resource allocations will be based on business cases that compare relative attractiveness of different projects

Cash Flow Dogma

- In finance, cash flow equals cash receipts (inflows) minus cash payments (outflows) over a given period of time.

- Cash inflows include revenues from sales and/or contract payments. On a contract basis, cash outflows include such items as payments for labor and material costs.

- Ideally, company's prefer projects that are either cash flow positive (inflows > outflows) or cash flow neutral (inflows = outflows). Projects with negative cash flow (outflows < inflows) may require the contractor to borrow funds thereby decreasing their earnings.

Getting to "Win-Win"… Contractor's Perspective

Fee Strategies

- Fee trend toward larger pools (15-20%) for prime integrators recognizes criticality of SE and Subcontract mgmt skills
- Align fee to mission performance with balanced upside/downside potential
- Include Base Fee – stimulates investment; favorably impacts IRR
- Effectively use "roll-over" provisions
- Tailor incentive fee structure to procurement (award fee, schedule incentive, cost incentive and/or performance incentive)

Cash Flow Strategies

- Billing/payment provisions can improve contractor motivation and resource investment
  - Allow incentive fee provisional billing
- Monthly interim/provisional fee billing is "win-win"
- Progress payments
- Preference for Cost Type Contracts
  - Cash paid and sales booked based on costs incurred

Example 1: Higher Profits vs. "The Deal"

- Industry's call for higher profits has been constant but the argument has evolved over time
  - 1980's - "We could make a better return by putting our money in the bank"
    - (Jun 82 avg mortgage rate was 15.57%)
  - 1990's - "We can't compete with the DotCom companies in the market, we need higher profits to attract investors
    - (Oct 99 Sycamore Systems market capitalization was near Boeing's)
  - 2000's - "Markets demand performance"
    - "We must achieve corporate goals for Return On Sales"
    - "Riskiest ventures are getting lowest returns" (Cost type development contracts)
- Is Industry's focus on higher profits/fee the best financial incentive to motivate performance?
  - Example uses Return on Sales (ROS) to measure the desirability of the deal

Return on Sales (ROS) versus Negotiated Fee Percentage (an Example)

Assume Cost Reimbursable–Award Fee Contract

Target (Allowable) Cost=	$100	
Negotiated Fee Percentage	=	13% or $13
Cost of Money	~	0.5% of Allowable
Earned Award fee	=	85% or $11.05

Return on Sales:

Booked Profit = Earned Fee + FCCOM

Sales = Target Cost + Booked Profit

Booked Profit = $11.05 + $0.50 = $11.55
Sales = $100 + $11.55 = $111.50
ROS = 11.5%

Good Job! (Or Was It?)

- Gomer comes bouncing in elated at the success of his negotiations. Instead of the 10% award fee we normally get from this customer, he got 12%. When his boss, Homer, asked how he managed that, Gomer said the customer was in a bind to sell his program and wanted us to take a 20% cost challenge. Gomer decided if we took a 20% challenge on cost, we should get 20% more in fee! Moner, in financial accounting, is overhearing this and moaning. **Is this a Good Deal?**

Moner's Right: Bad Deal!

Contract overruns to originally proposed target cost; irritated customer reduces the normal 90% award fee earned to 80%

	Normal Negotiation		Gomer's Deal
Target Cost	**$100**		**$80**
Target Fee =12% of $80	**$10**	**= 10% of $100**	**$9.6**
Actual Cost	**$100**		**$100**
Earned Fee =80% of $9.6	**$9**	**= 90% of $10**	**$7.68**
Sales =$100+7.68	**$109**	**= $100+9**	**$107.68**
ROS =$7.68/107.68	**8.3%**	**= $9/$109**	**7.1%**

All Elements of a Settlement Must be Considered - Cost, Profit and Performance Risk

Summary: Contractor Perspective

- Financial attractiveness considers both operating margin and cash flow
- Investment decisions and resource allocation depend on the business case
- Wall Street values companies based upon earnings which are directly impacted by cash flow

Current Incentives

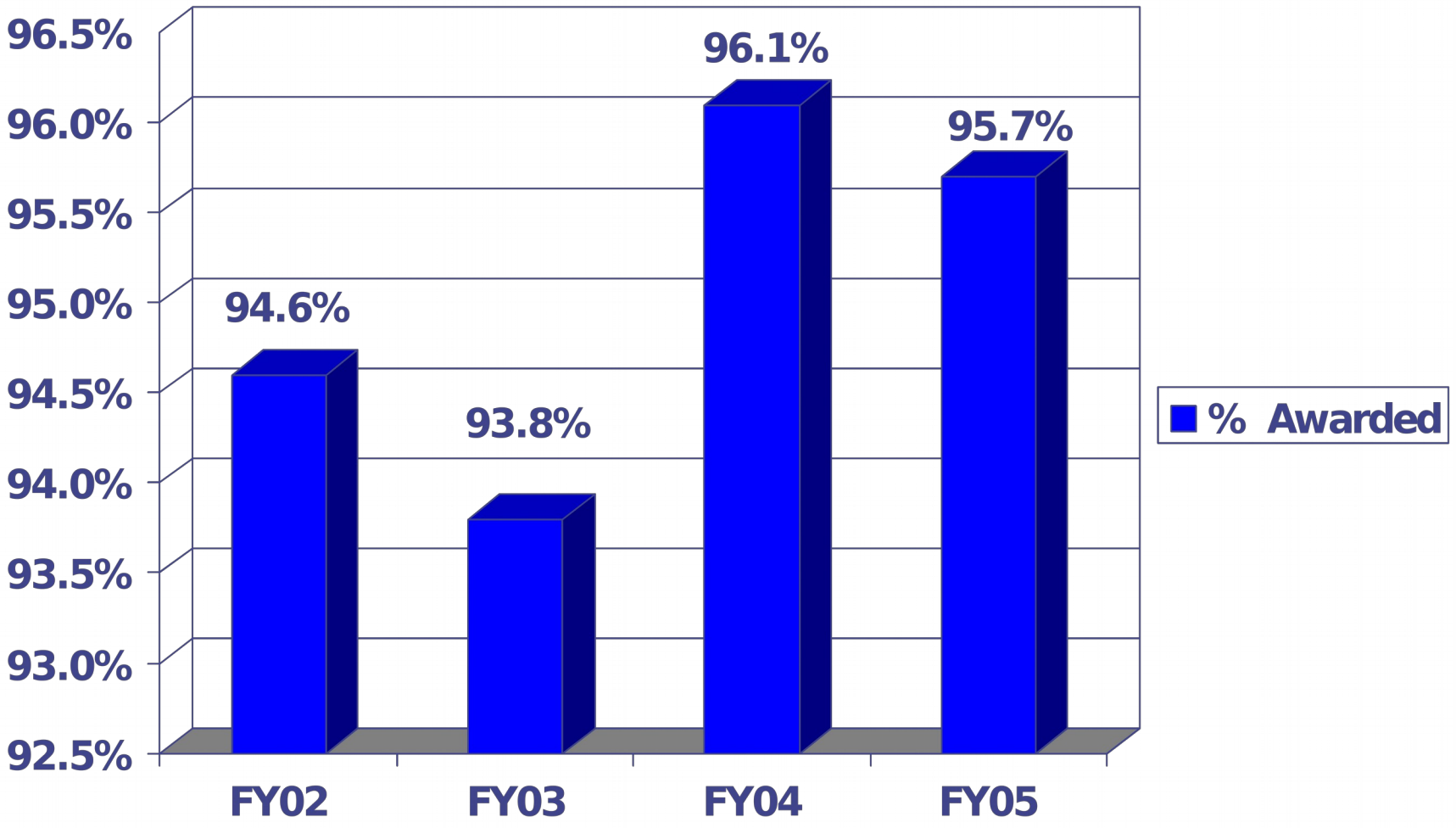
Cost Plus Award Fee (CPAF) Contracts are the Rule

- CPAF contracts consist of an estimated cost and an award fee amount that is paid upon periodic, subjective evaluations of the contractor's performance
- Award Fee consists of
  - Base fee (which may be zero) fixed at inception of the contract
    - Must not exceed 3% of estimated cost
    - Works the same as a Fixed Fee
  - Award amount based upon a judgmental evaluation by the Government
    - Subjective criteria

Award Fee Dogma

- CPAF contracts provide flexibility in two ways:
  - Subjective evaluation of contractor performance levels and the conditions under which the levels were achieved
  - Ability to adjust plans quickly to reflect changes in management emphasis or concerns
- The contractor must earn the award fee. Award fee starts at 0%, not at 100%
  - Contractor earns above average fee for above average work
- The award fee plan is a management tool. It provides a method to incentivize and reward a contractor for ideas, practices, or efforts that affect the end item of the contract in a positive way.

Earned Award Fee Trends Overall: 94.8% = "Excellent Performance"



Space Acq Developmental Programs Congressional Concerns

- 2006 Defense Authorization Act:

  " The committee is alarmed by the number of space acquisition programs experiencing unexpected cost growth over the past decade," the House Armed Services Committee said in the report accompanying its version of the defense authorization bill. "Virtually every major space acquisition program has experienced or sits dangerously close to a Nunn-McCurdy breach.

- Congressman Everett: "Space Acquisition Needs Reform"
  - "Exploding budgets"
  - "Protracted schedules"

Incentive-Fee Contracts

- Many incentive-fee contracts do not meet cost or performance targets
- Incentive-fee contracts are based on formula-like mechanisms
  - Determines amount of fee earned
  - Nature of fee criteria eliminates most of the subjectivity
- Cost, schedule or delivery and performance incentives are based on targets that can be evaluated against actual costs, actual dates and actual performance
  - Gives evaluators a clear sense of contractor's performance

Acquisition Developmental Programs Contract Incentives Concerns

- USAF concern: In relation to cost and schedule performance, award fee payments appear to be out of line
  - Programs consistently over cost & schedule
  - Award fees often in 90% range (SMC averages 95%)
- Senate Armed Services Committee requested the GAO review DoD's use of Award and Incentive Fees
  - Review use of award and incentive fee criteria used in contracts
  - Assess effectiveness of fees in motivating contractors to perform well
  - Draft report in work
- DoD reviewing Award Fee rollover provisions
  - Rollover allows contractors another chance to earn previously unearned award fee
  - DoD concerned over giving contractors a "second bite at the apple"

Bottom-line: We pay very high incentives but almost always get the product late and over cost!

THE FUTURE OF INCENTIVES

Performance-Based Contracting (PBC)

- PBC is contracting for results; not best effort
  - All aspects of acquisition structured around work to be performed
- Preferred method for acquiring services, R&D, and supplies
- PBC must have performance requirements, standards, and a performance incentive plan
  - Focus on required output not how the work is done

Performance-Based Incentives

- Full, on-orbit mission performance is primary objective
- Cost strategies must be balanced against risk of failure
  - Cost incentives must be adequate, but must not detract from emphasis on full mission performance
  - Minimize financial incentives for underruns
- Contractor to earn fee during contract performance but retains fee based upon mission performance
  - Full on-orbit mission performance is the only way contractor can retain all previously earned fee

Performance-Based Incentives Cont'd.

- Measurable, performance-based criteria must be identified prior to and during flight
- Cost plus incentive fee contract
  - No under run incentivized without approval
  - Can lose no more than 60% of total incentive fee as result of cost overrun
- Each space vehicle must be incentivized independent of success/failure of other vehicles

Basis of Mission Performance Determination

- Critical parameter list made part of contract
  - Based on contract requirements and technical specifications
  - Includes mission critical capabilities that may be affected due to malfunction or degradation
  - List includes required quantitative ranges for critical parameters and method of determination (telemetry, analysis, etc)
  - If more than one contractor involved, all critical parameters covered through combination of Fee Plans
  - Examples: system availability; system performance; data availability; timeliness; and utility

Critical Parameter Weights/Unique Considerations

- Numerical weights assigned in proportion to their mission criticality
- Expected Lifetime Non-availability
  - Such as periodic build-in down time to calibrate
  - Not effective until cumulative non-availability exceeded
- Post acceptance schedule – Such as accelerated re-test of stored vehicle
- Long term storage anticipated - Some earned fee may not be subject to repayment

Typical Fee Structure

- Up to 60% of fee subject to loss due to cost overrun
  - Cost incentive applied to all vehicles
  - Overrun near end of program can offset fees retained by the performance of previous vehicles
- May include schedule incentive
  - Amount at risk for contractor must be measured against importance of schedule and total cost to Government
- Must ensure that cost incentive does not reward contractor for meeting or exceeding performance requirements when results outweigh value
  - Technical performance demonstrated through pre-delivery test requirements
- May use award fee for subjective evaluation during design/development
  - Management, Technical, Financial,, Security, Operations, etc.

After Final Acceptance

- Contractor paid at DD250
- Thereafter – negative/payback only
  - Reinforces expectation of complete success
- Distribute total fee earned as of DD 250 from IOC through mean-mission-duration (MMD)
  - Amount applied to each period does not have to be uniform
- Fee loss due to less than full mission performance paid back with interest

Evaluating Mission Performance

- Establish performance equation based on weighted critical parameters
  - Include a subjective factor in formula that permits Government some unilateral adjustment
- Redundancy - Use of redundant feature does not always result in loss of fee
  - Fee is lost only for downtime between redundant systems
- No Opportunity to Perform
  - May be able to keep up to 60% of earned fee if mission failed due to no fault of contractor

Government Furnished Equipment (GFE) and Contractor Failure Equipment (CFE) failures

- Government determines whether mission failure due to GFE, CFE or inclusive
- CFE - Contractor is fully responsible
  - Includes equipment such as booster built by other division even if if was GFE for the contract
- GFE
  - Contractor is responsible if contractor caused failure or failed to detect through proper analysis
  - If Contractor not responsible, flight is scored
    - Based on performance up to that point on vehicle or average for all vehicles

Other Considerations

- Degradation not conclusively fault of contractor
- Should plan make provisions for the gradual degradation of performance over time?
- Flights are out of specifications limits
- Government option to fly vehicle with deficiency
- Government option to terminate flight earlier than planned duration
- Impact on contractor opportunity to perform if early vehicles exceed Mean Mission Duration

INCENTIVES SUMMARY

- Contractual incentives that are properly structured can maximize value for all parties
  - A successful business relationship recognizes the results the Government and contractor want to achieve while avoiding the undesirable outcomes.
- Challenge: determine what contractor behavior you want to motivate and then structure the proper incentive strategy to effectively motivate that behavior

BACKUP SLIDES

Financial Accounting Concepts

- Sales = Revenue
  - Total Cost + Profit/Fee + Cost of Money
  - Fixed Price: % Completion or delivery
  - Cost: When costs incurred
    - Includes T&M and other LOE contracts
- Net Income:
  - (Sales + Other Income) – (Cost of Sales + Interest Expense + Income Tax Expense)
- Earnings Per Share = Net Income/number of shares

Financial Accounting Concepts

- Cost of Capital
  - The required return necessary to make a capital budgeting project worthwhile
  - The rate of return that a firm would receive if they invested their money someplace else with similar risk
  - Invested money consists of a mix of bonds and equity
    - Costs related to retained earnings; bonds; common stocks; preferred stocks

- Hurdle Rate:
  - Minimum return required before making an investment
  - Commonly interest rate or cost of capital

Financial Accounting Concepts

- Return on Assets (ROA):
  - Net Income/Total Assets
  - Measures how efficiently profit is squeezed from assets
  - ROA > Cost of Debt

- Return on Equity (ROE):
  - Net Income/Total Shareholder Equity
  - Compare profitability across firms in the same industry
  - Measure of efficiency/competitive advantage
  - High debt; intangible assets; share buy-backs can skew data
  - 1998 – 2003: Dell: 46%; HP: 12%; Gateway: -2.5%

Financial Accounting Concepts

- Return on Sales (ROS):
  - Net Income/Sales
- Return on Invested Capital (ROIC):
  - (Net Income + After-tax Interest Expense)/ (Stockholders Equity + Debt)
  - Measures how effectively company used its capital
  - Used to make investment decisions
  - Incentive compensation for managers

Stock Price Risk Factors

- Earnings & Margins may vary based upon mix and type of contract
  - Fixed price: Overruns absorbed by company
  - Cost-reimbursement: Overruns absorbed by the Government
    - May not be reimbursed if costs are unallowable
    - Failure to meet performance expectations and contract requirements may result in reduced or loss of fees
    - Overruns may result in ability to sustain existing or obtain future contract awards

Source: Lockheed Martin 2004 Annual Report

Stock Comparison – Financial Data

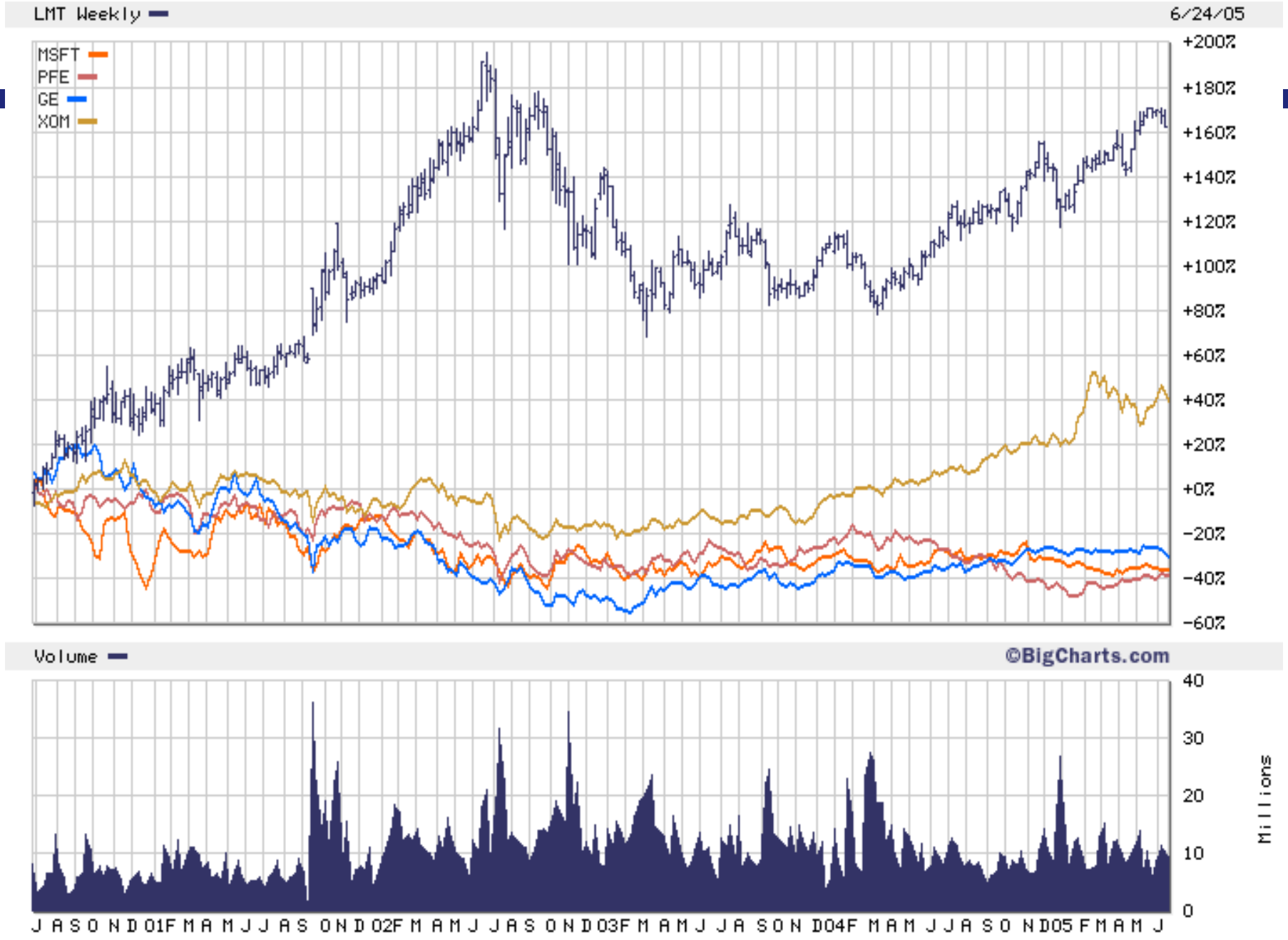
	Profit Margin	ROA	ROE	Debt/ Equity	EPS
LMT	4.4%	6.0%	21. 7%	0.70	$3.64
PFE	15.5%	7.4%	12.3%	0.10	$1.10
GE	11.2%	2.8%	16.5%	1.90	$1.76
MSFT	31.9%	15.5%	21.12%	0	$1.18
XOM	9.5%	17.0%	33.3%	0.08	$5.30

Source: Morningstar
As of 15 Jan 06

Stock Return Comparison

	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
LMT	3.6%	24.7%	7.9	16.1%	6.6%
PFE	4.8%	-3.7%	-5.5%	-8.4%	9.9%
GE	-0.4%	2.0%	13.9%	-3.5%	13.5%
MSFT	3.3%	2.2%	2.6%	3.2%	18.4%
XOM	6.6%	22.5%	22%	10.5%	13.5%

Source: Morningstar
As of 15 Jan 06


LMT Weekly
6/24/05
MSFT
PFE
GE
XOM
+200%
+180%
+160%
+140%
+120%
+100%
+80%
+60%
+40%
+20%
+0%
-20%
-40%
-60%
Volume
©BigCharts.com
40
30
20
10
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Millions
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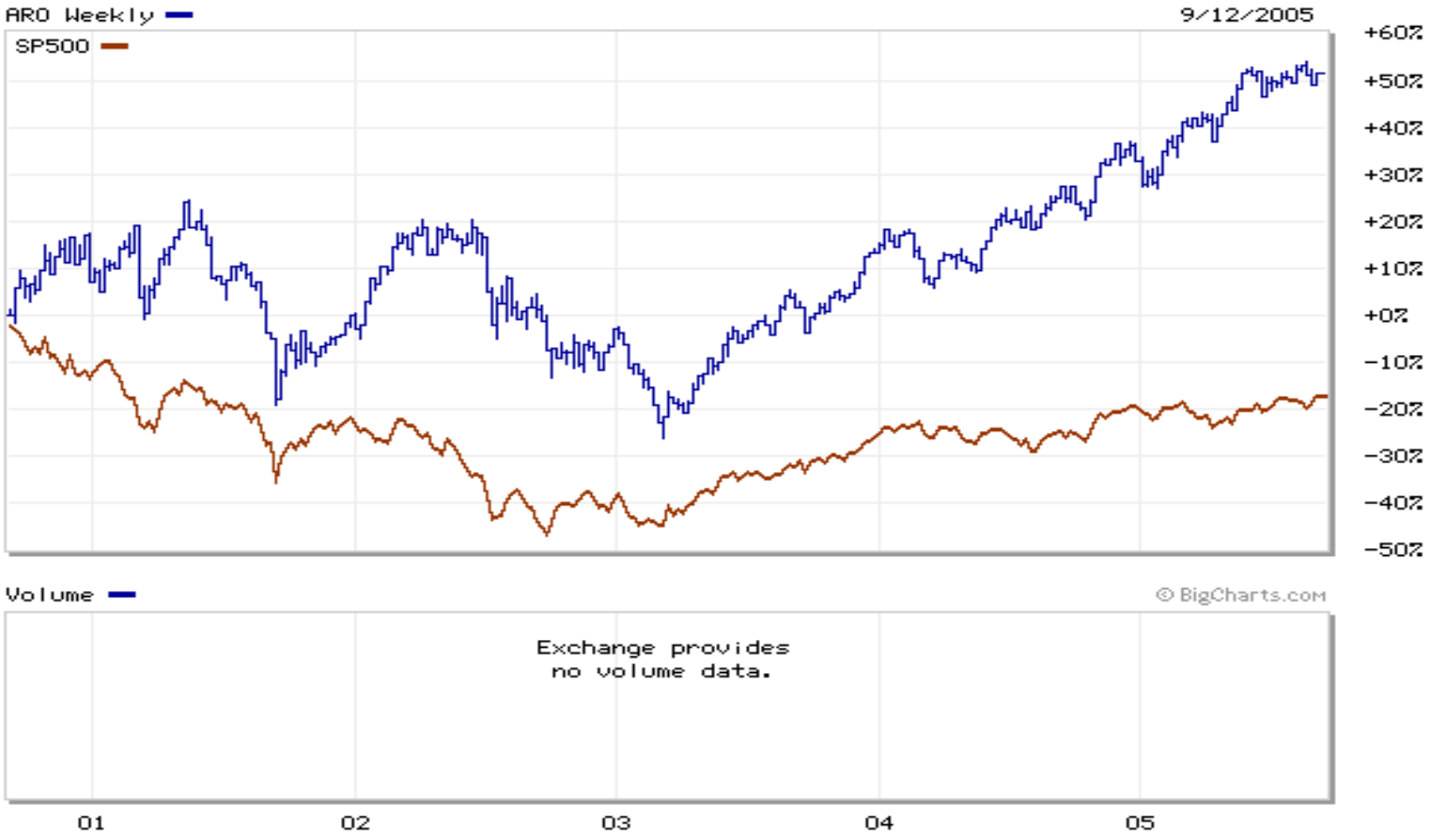
Stock Industry Comparisons

Industry	YTD	1 YEAR	3 YEAR	5 YEAR
Aerospace	1.2%	22.6%	19.0%	8.7%
Drugs	4.7%	12.5%	7.6%	-0.36%
Business Applications	4.0%	7.1%	7.8%	-4.3%
Energy	5.6%	42.0%	33.2%	17%
Electric Equipment	2.2%	7.3%	17.3%	-0.23%
S&P 500	3.5%	10.2%	13.4%	1.1%

Source: Morningstar

Defense Sector Vs S&P 500



Defense Sector Stocks out-performed the S&P 500 over the last 5 years

Financial Return Example

Example 2: LMT Cash Flow Analysis

- Background:
  - A corporation commits financial resources (ultimately cash) in performance of a contract.
  - A corporation makes an “investment” in a contract and expects to make an adequate financial return on that investment.
  - Investment decisions always involve analysis of cash flow
- How has LMT’s cash flow impacted their market performance?

2004 LMC Income Statement

Income Statement	2004 ($ m)
Sales	35,526
Less Cost of Sales	33,558
Operating Earnings	1,968
Plus Other Income	121
Total Income	2,089
Less Interest on Debt	425
Less Income Taxes	398
Net Earnings	1,266
Corporate ROS	5.9%

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2004 LMC Cash Flow

Cash In		**Cash Out**	
Operating Profit	1,266		
Add Dep & Amort	656		
Add Deferred Tax/Write	93		
Changes in Asst/Liab	429	Net Debt Payments	1,089
Add Other	480	Capital Investment	769
Cash from Operations	2,924	Acquisitions	91
		Investments/Other	126
Sale of Assets	279	Net Stock Buyback	673
		Dividends to S/Hs	405
Net Cash In	**3,203**	**Total Cash Out**	**3,153**

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2004 LMC Balance Sheet

Assets	$ m	**Liabilities**	$ m
Current		Current	
Cash	*1,060*	Adv. Payments	*4,028*
Receivables	*4,094*	Payables	*1,726*
Inventory	*1,864*	Salaries & Taxes	*1,346*
Other	*1,539*	Maturing Debt/Other	*1,466*
Total Current	8,953	Total Current	8,566
PP&E	3,599	Long-term Debt	5,104
Investments	812	Pension & Retiree/Other	4,863
Intangible Assets	8,564	**Total Liabilities**	**18,533**
Pension Assets	1,030	**Equity**	**7,021**

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Stock Comparison

	Profit Margin	Operating Margin	ROA	ROE	D/E	EPS
LMT	3.8%	5.7%	4.8%	18.6%	0.69	$3.01
PFE	17.6%	32.0%	8.7%	13.6%	0.29	$1.23
GE	11.0%	13.8%	1.9%	17.4%	3.30	$1.65
MSFT	28.9%	42.6%	9.5%	12.1%	0	$1.03
XOM	9.9%	14.8%	13.5%	14.8%	0.08	$4.28

Source: Morningstar